SECURITIES REGULATION— RULE 10b-5: DEVELOPMENT OF AN INQUIRY NOTICE STANDARD OF CONDUCT IN THE SECOND CIRCUIT

I. INTRODUCTION

One of the objectives of rule 10b-5,[1] promulgated pursuant to § 10(b) of the Securities Exchange Act of 1934,[2] is to prevent material misstatements or omissions in investment information. While it is clear that a private action for damages will lie under rule 10b-5,[3] a "great debate" has developed over the proper test to apply to the conduct of corporate personnel in determining whether liability should attach when misstatements or omissions occur.[4] Although at least one federal court of appeals has suggested the establishment of strict liability under rule 10b-5,[5] the debate focuses primarily on the acceptibility of a negligence standard as opposed to a requirement of scienter, or some degree of knowledge as to the existence of misstatements or omissions. This note traces the development of the standard of conduct in the Second Circuit. In doing so it identifies the emergence of an inquiry notice standard—one which leads to liability if the defendant has been placed on inquiry notice as to possibility of material misstatements or omissions and fails to investigate and disclose necessary information with reasonable care. The note also attempts a critical analysis of the various considerations employed by the Second Circuit in arriving at the establishment of an inquiry notice test.

II. THE DEVELOPMENT OF THE RULE 10B-5 STANDARD OF CONDUCT IN THE SECOND CIRCUIT

In analyzing and interpreting the scienter standard which the Second Circuit purports to establish, it is helpful to trace the history of the rule 10b-5 standard of conduct within the circuit. The development can effectively be divided into three stages: (1) the apparent move from a position which would require common law fraud for liability to the acceptance of a negligence test in private rule 10b-5 actions for damages;

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[1] 17 C.F.R. § 240.10b-5 (1973) [hereinafter referred to as rule 10b-5].

[2] 15 U.S.C. § 78j(b) (1970) [hereinafter referred to as § 10(b)].

[3] *See, e.g.*, Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 787 (2d Cir. 1951).

[4] *See* Globus v. Law Research Service, Inc., 418 F.2d 1276, 1290 (2d Cir. 1969), which discusses this "great debate."

[5] Ellis v. Carter, 291 F.2d 270, 274 (9th Cir. 1961). *See also* White v. Abrams, 42 U.S.L.W. 2518 (9th Cir. Mar. 15, 1974).

(2) the uncertain retreat from the negligence standard; and (3) the establishment of the principle of inquiry notice.

A. *From Fraud to Negligence*

The initial position assumed by the Second Circuit on the proper standard of conduct in rule 10b-5 private actions for damages was that espoused in *Fischman v. Raytheon Mfg. Co.*[6] In *Fischman* the court adhered to the traditional common law requirement that actual fraudulent intent must be proved to effect recovery in private actions for damages.[7] The court did not consider the possibility that a less strict standard might be more appropriate. Although the Second Circuit had modified this position somewhat by 1967, and had spoken of "some form of the traditional scienter requirement,"[8] no specific test had been established to replace the strict fraud standard.

The Second Circuit significantly departed from a fraud or modified fraud-scienter position in private rule 10b-5 actions for damages in the landmark case of *SEC v. Texas Gulf Sulphur Co. (TGS)*.[9] The *TGS* court held that in future actions by the Securities and Exchange Commission for "equitable or prophylactic" relief, negligent conduct would constitute a violation of rule 10b-5.[10] A fraud or modified fraud-scienter standard would not be required in such a suit. The holding did not involve a *private* rule 10b-5 action for damages. Nevertheless the court proceeded to suggest a perhaps more significant ramification in the development of rule 10b-5. The majority opinion strongly urged that negligence should also constitute a sufficient basis for relief in a private action for damages.[11] The court stated:

> A similar standard [of negligence] has been adopted in private actions . . . for policy reasons which seem perfectly consistent with the broad Congressional design ". . . to insure the maintenance of fair and honest markets . . . in securities transactions.
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> [T]he securities laws should be interpreted as an expansion of the common law . . . to effectuate the broad remedial design of Congress. . . . Moreover, a review of other sections of the Act from which Rule 10b-5 seems to have been drawn suggests that the implementation of a standard of conduct that encompasses negligence as well as active fraud

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[6] 188 F.2d 783 (2d Cir. 1951).

[7] *Id.* at 786.

[8] Barnes v. Osofsky, 373 F.2d 269, 272 (2d Cir. 1967).

[9] 401 F.2d 833 (2d Cir. 1968).

[10] *Id.* at 854-55.

[11] *Id.* at 855.

comports with the administrative and the legislative purposes of the Rule."[12]

This dicta was interpreted by many commentators to mean that those responsible for disseminating information to the investing public would be obligated to investigate matters which might prove material in making an investment decision, and to disclose the information in a manner that would not be misleading.[13] Liability would arise if the duty was not performed with reasonable care. Imposing such an affirmative duty to investigate was a significant break with the past since it was the first time that actual knowledge of the misstatement or omission had not been necessary to trigger liability in a *private* suit for damages. This departure was quite abrupt in that it bypassed a middle position which would have required some form of *constructive* knowledge for liability to arise in rule 10b-5 private damage actions. The element of knowledge, however, has no relevance to a negligence standard of conduct.

B. *The Retreat from Negligence*

The *TGS* pronouncement that negligence would violate the rule 10b-5 standard of conduct was not to stand for long in the Second Circuit. The series of cases following *TGS* evidenced a break from the negligence test as well as a continuing struggle within the Second Circuit over the correct test to apply to conduct in a rule 10b-5 private action for damages.

Shortly after *TGS*, the Second Circuit avoided an opportunity to affirm negligence as its standard in private rule 10b-5 damage actions in *Heit v. Weitzen*.[14] Dealing only with the sufficiency of the plaintiff's

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[12] *Id.* (Citations omitted).

[13] *See, e.g.*, VI L. LOSS, SECURITIES REGULATION 3887-88 (2d ed. 1969) (indicating that the Second Circuit watered down the scienter requirement in *TGS*—following the trend among the circuits); 2 A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10B-5, §§ 8.4 (504), 8.4(506)(1971); Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sales Cases*, 63 NW. U.L. REV. 423, 444-46 (1968).

Three *basic* alternatives were given in Comment, *Negligent Misrepresentation Under Rule 10b-5*, 32 U. CHI. L. REV. 824, 827 (1965).

> (1) absolute liability—the fact that the statements made were false or misleading is sufficient to establish liability regardless of the defendant's state of mind; (2) intentional liability—the false or misleading statements must have been made knowingly or with intent to mislead; (3) negligence liability—the defendant will not be liable if he was unaware of the deception and could not have cured it by the exercise of reasonable care.

Following (1) *see, e.g.*, Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961). Following (3) *see, e.g.*, Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1971); Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 104 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971); City National Bank v. Vanderboom, 422 F.2d 221, 229-30 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963).

For a comparison of the circuits see A. BROMBERG, *supra*, § 8.4(585).

[14] 402 F.2d 909, 913-14 (2d Cir. 1968).

complaint, the court in *Heit* found that the plaintiff's allegations that defendants "knew or should have known" of material misinformation properly stated a claim for relief.[15] The alternative allegations were sufficient to cover both knowledge of the misstatements and negligence in failing to investigate, and consequently were sufficient as a matter of pleading.[16]

Conspicuously absent from the *Heit* discussion was language to reinforce the *TGS* suggestion that negligence alone would be sufficient in a private action for damages. The *Heit* court noted that the *TGS* language was dicta and that the "troublesome question" of the establishment of a negligence as opposed to a scienter standard had yet to be decided.[17] Although the language in *TGS* did constitute dicta, the *TGS* court expressed no doubt over the position it would take should an occasion arise in which a definite holding was necessary. The *Heit* discussion therefore fell as a warning that, despite previous indications to the contrary, the Second Circuit might decide against a negligence standard and in favor of a scienter requirement in a private rule 10b-5 action for damages when directly confronted with that issue.

Globus v. Law Research Service, Inc.,[18] which followed *Heit*, also indicated that the scienter issue was not yet decided, while also avoiding an affirmation of any specific standard. The defendants in that case requested the trial judge to charge the jury that to find for the plaintiffs it must conclude that the defendants *intended* to defraud plaintiffs.[19] The trial judge rejected this request, which called for a standard of conduct requiring actual fraud. He likewise rejected the *TGS* suggestion that negligent conduct on the part of the defendants would be sufficient to state a valid claim for relief. The judge charged that some form of scienter—more than mere negligence—must be demonstrated for plaintiffs to recover in the private rule 10b-5 action for damages.[20]

On appeal the Second Circuit agreed with the trial judge that a "scienter requirement equal to the 'intent to defraud' required for common law fraud" was no longer necessary in a rule 10b-5 action. However, the court made no determination as to the correctness of the instruction given by the trial court that negligence would not satisfy a valid claim for relief; it merely stated that even if negligence *were* the correct

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[15] *Id.* at 914.

[16] *Id.*

[17] *Id.* at 913-14.

[18] 418 F.2d 1276 (2d Cir. 1969), *cert denied*, 397 U.S. 913 (1970).

[19] *Id.* at 1290-91. The requested charge would require actual fraud and is similar to the standard upheld in *Fischman*, *supra* note 7 at 786.

[20] 418 F.2d at 1290-91.

standard, a negligence charge would have weighed more heavily against the defendants than the charge given by the trial judge requiring some form of scienter. Thus, since the defendants lost at the trial level, the charge contained no prejudicial error.[21] The court also indicated that the issue of negligence versus scienter was not yet settled, terming the dispute "the great debate."[22]

The Second Circuit at last clearly repudiated the negligence standard in a private action in *Shemtob v. Shearson, Hammill & Co.*[23] There it required that the plaintiff allege facts indicating scienter, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme, or artifice to defraud. Allegations of "mere negligence" did not, held the court, state a claim for relief under rule 10b-5.[24] Finally, therefore, the uncertainty over whether or not the Second Circuit would adopt a negligence test in a private rule 10b-5 action for damages had been settled. Some form of scienter—more than mere negligence—was now necessary for liability to attach within the Second Circuit.

C. *The Establishment of Inquiry Notice*

The series of cases from *TGS* to *Shemtob* illustrates the retreat by the Second Circuit from a negligence standard in private rule 10b-5 actions for damages.[25] The precise test that was established cannot, however, be clearly discerned from these cases. Consequently the focus in the Second Circuit has shifted to the establishment of a specific standard by which to measure a defendant's conduct in a private rule 10b-5 action.

The initial step by the Second Circuit in its attempt to arrive at a precise determination of its scienter requirement was taken in *Cohen v.*

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[21] *Id.* at 1291.

[22] "Thus, whatever the outcome of the great debate over ordinary negligence versus scienter in private actions under § 10(b) and Rule 10b-5, see SEC v. Texas Gulf Sulphur, . . . it is clear that . . . [the] instruction satisfied the scienter requirement imposed by prior cases." *Id.* at 1291.

[23] 448 F.2d 442 (2d Cir. 1971).

[24] *Id.* at 445.

[25] Judge Friendly's concurring opinion in *TGS*, which argued that private plaintiffs should be required to allege some form of scienter, provided the basis for the court's retreat from the *TGS* majority negligence standard. 401 F.2d at 866-69. Three judges concurred with Judge Friendly on that issue and two judges dissented from the majority. Thus, only four members of the nine-member court actually favored a negligence position. *See* Heit v. Weitzen, 402 F.2d 909, 913 (2d Cir. 1968) (referring to Judge Friendly's concurring opinion in *TGS*); and Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1968) (citing pages in *TGS* which fell within Judge Friendly's concurring opinion). The subsequent confusion in the *Heir-Shemtob* series of cases implies a struggle among the opposing factions of the court to promote their prospective positions.

Franchard Corp.[26] This case itself did not clearly indicate which standard the court was adopting. Nevertheless, the decision in *Franchard*, when analyzed in light of a subsequent case, *Lanza v. Drexel & Co.*,[27] suggests that the court has begun to focus on an acceptable standard.

1. Cohen v. Franchard Corporation

Franchard involved a real estate scheme whereby a partnership (Associates) was formed to purchase one apartment building and the land upon which to build another; Franchard Corporation was engaged to maintain Associates' financial records. To raise necessary capital, promotional material was issued by the general partners to encourage the purchase of limited partnership shares. This material advertised a projected return on investment based upon a net lease which had been negotiated with a lessee company, also controlled by the general partners, but it failed to disclose the financial condition of the net lessee. Subsequent to the issuance of the limited partnership shares, the lessee filed a petition for an arrangement under Chapter 11 of the Bankruptcy Act and was evicted. A new net lessee agreed to pay a price far below the original net lease price, thereby lowering the return on investment. Finally the partnership was dissolved.[28]

Purchasers of limited partnership shares believed that Franchard Corporation and the general partners of Associates had defaulted upon an obligation to investigate and disclose pertinent financial information which would have warned investors of the net lessee's financial difficulties. They initiated a class action on behalf of all limited partners, alleging violations of § 10(b) and rule 10b-5.[29]

The trial court rejected the purchasers' request for a "mere negligence" charge and charged the jury that "reckless disregard for the truth" must have been established in order for the plaintiffs to recover.[30] On appeal the Second Circuit held that the trial court's "charge on scienter was essentially correct."[31] The Second Circuit nevertheless appeared confused in *Franchard* and did not clearly indicate the precise standard of conduct which it was adopting. The court's language could be interpreted as requiring either (1) a standard between fraud and negligence (some form of knowledge or scienter); (2) a standard close to common law fraud (reckless disregard for the truth); or (3) a standard of negli-

[26] 478 F.2d 115 (2d Cir. 1973).
[27] 479 F.2d 1277 (2d Cir. 1973).
[28] 478 F.2d at 117-20.
[29] *Id.* at 119, 120-21, 123.
[30] *Id.* at 123.
[31] *Id.* at 124.

gence (reasonable grounds to believe in the existence of material misstatements or omissions).

First, it may be inferred from *Franchard* that some form of scienter is necessary for rule 10b-5 liability. After the court stated that it had uniformly held in the past that a party could not be found liable for "mere negligent conduct" under rule 10b-5, it announced that for liability to attach the defendant must to some extent be cognizant of a misstatement or omission; he must possess some degree of knowledge.[32] The court then referred to the ALI Federal Securities Code definition of "knowledge" which comprises (a) actual knowledge, and (b) constructive knowledge, by which knowledge can be inferred.[33] Constructive knowledge, according to the code, includes "reckless disregard for the truth" as well as "the case of a defendant who is honestly convinced of the truth of the statement . . . but knows that the person with whom he is dealing will assume . . . a clearly more reliable source for his belief."[34] The definition of knowledge then would appear to parallel the court's "some form of scienter" requirement.

Second, the *Franchard* court appeared to adopt a standard close to common law fraud by accepting the trial judge's charge, which required proof of reckless disregard for the truth before liability could arise.[35] As has been discussed above, the ALI definition of knowledge goes beyond reckless disregard for the truth. Therefore, by using this reckless disregard for the truth language, the court severely limited the constructive knowledge test implicitly adopted by use of the ALI definition. Reckless disregard comes very close to a return to the "fraud" requirement espoused in *Fischman v. Raytheon Mfg. Co.*,[36] since an action for common law deceit (fraud) encompasses reckless disregard for the truth, which can be either a belief that a statement is untrue or a total *lack* of belief that it is true.[37] Reckless disregard for the truth is com-

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[32] *Id.* at 123.

[33] *Id.* at 123 n.11.

ALI Federal Securities Code, § 251A (Tent. Draft No. 2, 1973):

> [Knowledge.] When reference is made to this section, a misrepresentation is known by a person to be a misrepresentation if he (a) knows or believes that the matter is otherwise than represented, (b) does not have the confidence in its existence or nonexistence that he expresses or implies, or (c) knows that he does not have the basis that he states or implies he has for his belief.

[34] ALI Federal Securities Code, § 251A (Tent. Draft No. 2, 1973) (Comment 3).

[35] 478 F.2d at 123-24.

[36] 188 F.2d 783, 786; *see* text accompanying note 6, *supra*.

[37] A. BROMBERG, *supra* note 13, § 8.4(110).

Professor Loss states:

> A number of cases have required some showing of "fraud." The leading case in

prised of the same elements as is common law fraud, except that an intent to harm, while a necessary element of common law fraud, is not an ingredient of reckless disregard for the truth. Consequently, a person who has acted with reckless disregard for the truth in failing to disclose information or in disclosing misleading information would have been conscious of the misstatements or omissions, but would not have intended that harm result to the prospective investors. Indeed he may have even been hopeful that no harm would have followed, or merely disregarded the possibility that investors might be misled.[38]

Third, there are indications of the acceptance of a negligence standard in *Franchard*; the language which the court expressly said would correctly allege a violation of rule 10b-5 in private actions for damages amounts to negligence according to Comment (4) of the ALI definition of "knowledge."[39] Comment (4) states that when a negligence standard is desired, the phrase to be used is "knowledge or reasonable grounds to believe." Despite its announced rejection of the negligence standard, this language was used by the *Franchard* court when it stated

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> this camp is Fischman v. Raytheon Mfg. Co. [Citation omitted]. See also . . . Trussel v. United Underwriters, Ltd., 228 F. Supp. 757, 771-72 (D. Colo. 1964), . . . (the statutory language "implies conduct which is at the very least, either knowing or intentional, *although reckless disregard of the truth may suffice without actual knowledge.*").

L. LOSS, *supra* note 13, at 3885 (emphasis supplied).

As will be seen below, the court appears to relax the standard to more closely represent "mere disregard" for the truth rather than "reckless disregard." It is doubtful, nevertheless, that the trial court ascribed the same meaning to the words as did the Second Circuit. The court's dissatisfaction with the plaintiffs attorneys may well have spurred the court to accept the "reckless disregard" standard, yet with its heretofore unexpressed liberalized interpretation. The court stated: "This is a striking example of a case that never should have been claimed for a jury trial, as plaintiffs' counsel did. That, coupled with what appears to have been a lack of preparation in addition to visibly inept trial conduct on the part of plaintiffs' counsel, is about all that distinguishes this from what otherwise would be an uncomplicated appeal." 478 F.2d at 117. *See also, id.* at 120-22, 125.

[38] The Restatement of Torts suggests that recklessness differs from intentional misconduct (fraud) in that the person did not intend the harm to result:

> While an act to be reckless must be intended by the actor, the actor does not intend to cause the harm which results from it. It is enough that he realizes or, from the facts which he knows, should realize that harm may result, even though he hopes or even expects that his conduct will prove harmless.

RESTATEMENT OF TORTS, EXPLANATORY NOTES § 500, comment *f* at 1296 (1934). *See also* Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sales Cases*, 63 NW. U.L. REV. 423, 436 (1968):

> If he has no intent to injure, he may nevertheless know the existence of the true facts. In such a case if he makes a misrepresentation or fails to disclose, his conduct is "knowing" in the sense that he acts in the belief that investors may be misled by his misrepresentations or nondisclosures. His conduct will be "reckless" if he acts in conscious disregard of, or indifference to, the risk that they will be misled.

[39] ALI Federal Securities Code, § 251A (Tent. Draft No. 2, 1973) (Comment 4).

that for a plaintiff to recover in a private rule 10b-5 suit for damages he must prove either (1) that the defendant knew of the material misstatement or omission, or (2) that he "failed or refused to ascertain and disclose such facts when they were readily available to him and *he had reasonable grounds to believe that they existed.*"[40]

The "negligence" language probably carries more significance than the other language of the court since the court expressly stated that the "reasonable grounds to believe" test was the correct standard for determining liability. But when the court combines this language with that of "reckless disregard for the truth" and "some form of scienter" it indicates that negligence does—yet does not—suffice for a private plaintiff to recover damages under rule 10b-5.

The apparent contradiction may be resolved by differentiating between "negligence" and "mere negligence," since it was "mere negligence" that the court had repeatedly rejected.[41] The analysis will illustrate that the Second Circuit appears to be groping toward an inquiry notice standard.[42]

Acts that constitute negligence depend on the existence of a legal duty and the breach or failure to carry out that duty with the exercise of reasonable care.[43] Consequently, when the nature of the duty is altered, the meaning of negligence naturally changes also. "Mere negligence" is characterized by (1) the existence of an affirmative duty to investigate material matters *despite* the non-existence of facts which would have put the defendants on notice as to any misstatements or omissions, and (2) the failure by the defendants to carry out the duty with reasonable care. The plaintiffs in *Franchard*, by requesting the establishment of an affirmative duty to investigate, therefore, requested a charge of "mere

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[40] 478 F. 2d at 123 (emphasis supplied).

[41] *See, e.g.*, Republic Technology Fund, Inc. v. The Lionel Corp., 483 F.2d 540, 551 (2d Cir. 1973) ("something more than '*mere' negligence*"); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1301 n.20 (2d Cir. 1973) ("whether it was willfully misleading or *merely negligently* drafted"); Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 397 (2d Cir. 1973) ("purpose was not to punish *mere negligence*"); Cohen v. Franchard Corp., 478 F.2d 115, 123 (2d Cir. 1973) ("We uniformly have held that a party cannot be held liable in a private suit for damages under Rule 10b-5 *mere negligent* conduct."); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1096 n.15 (2d Cir. 1972) ("more than *mere negligence* is required"); Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971) ("It is insufficient to allege *mere negligence*"); Globus v. Law Research Service, Inc., 418 F.2d 1276, 1290 (2d Cir. 1969) ("some form of scienter greater than *mere negligence* was required") (emphasis supplied in all examples).

[42] The concept of "inquiry notice" was discussed by Professor Shipman as applied to the standard of conduct for attorneys under § 11 of the Securities Act of 1933. Shipman, *The Need for SEC Rules to Govern the Duties and Civil Liabilities of Attorneys under the Federal Securities Statutes*, 34 OHIO ST. L.J. 231, 266-69 (1973) (inquiry notice "requires one to investigate possible defects concerning which he has been put on notice").

[43] W. PROSSER, LAW OF TORTS 143 (4th ed. 1971).

negligence," which the court rejected.[44] "Negligence," on the other hand, as stated by Comment (4) to the ALI definition of "knowledge," cited in *Franchard*, is the equivalent of "inquiry notice." Inquiry notice does not establish an affirmative duty to investigate. The duty to investigate arises only when the defendants are in some manner *put on notice* of the possible existence of material misstatements or omissions, that is, when they have reasonable grounds to believe that the misstatements or omissions exist. Consequently, by defining the correct test as whether the defendants had "reasonable grounds to believe" that a misstatement or omission exists, the *Franchard* court appears to have established an inquiry notice standard. It would be advisable, however, not to speak in terms of "negligence," since use of the term results only in confusion. Instead, language should be framed in terms of the existence of a duty and the breach of the duty.[45]

2. Lanza v. Drexel & Co.

The more recent case *Lanza v. Drexel & Co.*[46] clarifies the Second Circuit's acceptance of the inquiry notice test and in doing so significantly expands the meaning of "reckless disregard for the truth." *Lanza* involved the liability of an outside director for failing to investigate and disclose the inaccuracy or omission of material matters in information conveyed to plaintiff, a prospective investor. The critical information that was not provided to plaintiff was the deteriorating financial stability of the corporation he was buying into. The court adopted as its scienter standard the requirement for defendant to have acted in "reckless disregard for the truth." It then held that although the outside director knew of the financial problems of the corporation and of the accompanying internal strife, he was not liable for reckless disregard for the truth because this knowledge was not sufficient to put him on notice that the insiders had withheld the information from the plaintiff.[47]

Lanza differs from *Franchard* in that *Franchard* dealt with insider conduct. Insiders are generally held to a higher standard of conduct than outsiders;[48] consequently, if the inquiry notice standard is adopted to judge the conduct of outsiders in *Lanza*, a standard at least as stringent should apply to the insiders in *Franchard*. However, the Second Circuit does not distinguish between outside corporate officials and inside

[44] 478 F.2d at 123.

[45] The Ninth Circuit in White v. Abrams, 42 U.S.L.W. 2518 (9th Cir. Mar. 15, 1974) adopted a similar analysis.

[46] 479 F.2d 1277 (2d Cir. 1973).

[47] *Id.* at 1288, 1306-09.

[48] *Cf.* Escott v. BarChris Construction Corp., 283 F. Supp. 643, 687-97 (S.D.N.Y. 1968).

officers and directors in determining the applicable rule 10b-5 standard of conduct; the same test would be applied to both types of defendants. It is logical that an outside director would be less likely to be found liable under an inquiry notice standard than an insider, simply because an insider, involved in the day-to-day operations of the corporation, is put on notice of a much larger volume of material information, including possible misstatements or omissions, than an outsider. Nevertheless, the inquiry notice standard appears to apply both to insiders and outsiders.

If the inquiry notice test applied only to outsiders, while a more severe test applied to insiders, the logical result would appear to be a return to the imposition on insiders of an affirmative duty to investigate (negligence). The adoption of an affirmative duty to investigate was urged in dicta in *TGS*, but was clearly rejected in subsequent cases.[49] *Lanza*, while refusing to impose liability on an outside director because he was not aware of the inaccurate disclosure, did not state that the insiders were liable under a *stricter* standard.[50] It indicated that the insiders had knowledge of the misstatements and omissions conveyed to plaintiff.[51] This conduct easily fits within the inquiry notice standard, since inquiry notice is comprised of both actual knowledge of misstatements or omissions *and* information sufficient to make defendants aware that such misstatements or omissions might exist.

After the *Lanza* court affirmed a charge requiring reckless disregard for the truth by defendant in order for liability to arise it defined reckless disregard for the truth and included inquiry notice in the definition:

> In determining what constitutes "willful or reckless disregard for the truth" the inquiry normally will be to determine whether the defendants knew the material facts misstated or omitted, or failed or refused, *after being put on notice* of a possible material failure of disclosure, to apprise themselves of the facts where they could have done so without extraordinary effort.[52]

The *Lanza* definition indicates two things. First, it expressly supports the inquiry notice standard suggested by *Franchard*; it negates the existence of a general affirmative duty to investigate and requires such in-

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[49] *See* text accompanying notes 12-24, *supra*.

[50] 479 F.2d at 1280, 1305-06, 1306 n.98 (the court discusses the reckless disregard standard and does not indicate that different standards apply to outsiders than to insiders).

[51] *Id.* at 1280. The court stressed that the outside director, unlike the insiders, was not present at the meetings in which negotiations with plaintiffs for an exchange of stock in the two corporations was carried on, and, consequently, unlike the insiders was not aware of the information inaccurately conveyed to plaintiffs. The court also pointed out that the insiders were aware of the decrease in financial stability of the corporation of which the defendant was a director. *Id.* at 1283-89.

[52] *Id.* at 1306 n.98 (emphasis added).

vestigation only when information sufficient to put a defendant on notice of the possibility of a material misstatement or omission arises. Second, it significantly liberalizes the interpretation of "reckless disregard for the truth,"[53] and thereby releases it from the near fraud definition provided in *Fischman v. Raytheon Mfg. Co.*[54]

The apparent contradictions of *Franchard* can now be harmonized in light of *Lanza*. Since "reckless disregard" can now be treated in the Second Circuit as the equivalent of inquiry notice, the contradiction between the *Franchard* acceptance of both the reckless disregard and reasonable grounds to believe (inquiry notice) language disappears. Further, the *Franchard* court did not incorporate the ALI definition of "knowledge" in express terms, indicating possible slight differences between the court's "some degree of knowledge" and the ALI definition. "Some degree of knowledge" could, therefore, be viewed as equivalent to inquiry notice. Consequently, the language in *Franchard* which seemed to indicate fraud, negligence, and some middle ground (some form of scienter or knowledge) can be harmonized as being equivalent to inquiry notice.

While *Lanza* confirms the inquiry notice standard in the Second Circuit, the dissenting opinion of Judge Timbers in *Lanza* suggests a possible shift of focus in the debate over the applicable standard. He stated that it would be unnecessary in *Lanza* to determine whether an affirmative duty to investigate should be established. The facts in the case viewed as a whole, Judge Timbers asserted, were sufficient to put the defendant-director on "notice," and consequently he should have been held liable for "reckless disregard for the truth." Judge Timbers considered that the expertise and experience of the defendant, combined with the fact that the corporation suffered many business reversals in the past and was presently experiencing significant internal strife, should have placed the defendant-director on notice to investigate and determine whether material information was withheld from the plaintiffs.[55] Consequently, the struggle within the Second Circuit may in future cases shift from the debate over negligence versus scienter to concern over the type of conduct that constitutes the minimum degree of notice that is required to establish a duty to investigate. It would be

[53] *See* text accompanying notes 35-38, *supra*. The original meaning of reckless disregard is comprised of knowledge of misstatements or omissions, but without the intent to harm, and with conscious disregard of the possible harm that might result. Inquiry notice, however, reflects a situation where a person does not know of the misstatements or omissions, but receives information to make him aware that possible inaccuracies or omissions may have occurred.

[54] 188 F.2d 783 (2d Cir. 1951).

[55] 479 F.2d at 1320-22 (dissenting opinion).

mere speculation to suggest how far Judge Timbers would go in determining what constitutes notice; however, his minimal requirements might possibly approach "mere negligence" which the court in the past has disapproved. Judge Hays' dissent argued for the imposition of a positive duty on the defendant to investigate, without a notice requirement.[56]

III. A Critical Analysis of the Second Circuit's Adoption of the Inquiry Notice Standard

The inquiry notice standard, as stated above, would not establish an affirmative duty to investigate. Such a duty would arise only when sufficent information has come to the attention of a corporate officer or director to place him on notice of the existence of possible material misstatements or omissions. Inquiry notice stands in contrast to the negligence standard approved by the Seventh Circuit to cover private rule 10b-5 actions for damages.[57] That circuit has suggested a standard which would establish an affirmative duty to investigate, thereby creating a form of fiduciary relationship between corporate personnel and prospective investors which imposes a greater duty on them than merely to abstain from fraudulent practices. The duty is required to be exercised with "reasonable and due diligence" to ascertain what is material and would affect the judgment of prospective investors. Whether the "reasonable and due diligence" requirement has been met would depend on the totality of the facts and circumstances of the particular case. The *actual* business skill of the corporate officer or director and the *normal* business acumen of one in the position of the officer or director would constitute prime factors in determining whether the duty was performed with reasonable care.[58]

The Second Circuit, as illustrated above, has rejected the imposition upon corporate personnel of an affirmative duty to investigate and has

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[56] *Id.* at 1317-20 (dissenting opinion).

Note that four judges dissented from the majority and would impose a negligence standard upon defendant conduct in private rule 10b-5 actions for damages. The split in the Second Circuit, therefore, remains 5-4 opposed to a negligence standard, just as in *TGS*. *See* note 25, *supra*. *See also* White v. Abrams, 42 U.S.L.W. 2518 (9th Cir. Mar. 15, 1974).

[57] *See, e.g.*, Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963).

[58] *Id.* at 641-42.

The Seventh Circuit also indicated that the fulfillment of fair and honest business practices in a spirit of good faith under all circumstances would be an overriding consideration. However, the court did not mean to suggest good faith in the sense of *inaction* due to the non-existence of a situation which would place an insider on inquiry notice (good faith in investigating only subsequent to inquiry notice); rather it referred to good faith in aggressively seeking out any material matter that might affect an investment decision. Presumably the absence of good faith could be inferred from the lack of diligence or reasonable care in exercising the duty to investigate.

established an inquiry notice standard of conduct in private rule 10b-5 actions for damages. This section of the note attempts to analyze the various considerations which have lead the Second Circuit to adopt an inquiry notice test and to reject the imposition of an affirmative duty to investigate. It also attempts to raise and answer certain objections which the Second Circuit has asserted in rejecting a negligence standard. Finally, this section suggests a primary policy consideration which the Second Circuit has overlooked in accepting inquiry notice as its standard of conduct in private rule 10b-5 actions for damages.

A. *Considerations Supporting Inquiry Notice*

1. Fear of Unlimited Liability

The decision by the Second Circuit in *Franchard* and *Lanza* not to place an affirmative duty to investigate upon corporate personnel appears to be traceable to the fear of creating potential unlimited liability.[59] As the Second Circuit stated in *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*,[60] the requirement of some degree of scienter functions to impose liability on those whose conduct has been sufficiently culpable to justify the penalty.[61] When a person has been placed on notice of the possible existence of material misstatements or omissions, a court will be less reluctant to impose potentially unlimited liability since the defendant has had the opportunity to investigate such matters, and failure to do so would reflect the defendant's own culpability or some degree of bad faith. When a person acts in good faith, however, and only through negligence overlooks material information, his conduct is much less blameworthy. In such a case liability might be imposed without hesitation if the possibility of unlimited liability were slight. However, in a rule 10b-5 case where thousands of investors and millions of dollars might be involved in a damage action, a court might be extremely reluctant to create liability without some degree of bad faith. This reasoning provides a compelling argument for the inquiry notice standard.

Yet the Second Circuit might appropriately reach an opposite conclusion and impose an affirmative duty to investigate if some means were available to spread or limit the risk. There are several approaches which could be taken to reach this result, the first of which is the availability

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[59] Judge Friendly expressed this concern in his concurring opinion in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 866-69 (2d Cir. 1968). *See also* Gerstle v. Gable-Skogmo, Inc., 478 F.2d 1281, 1300 (2d Cir. 1973).

[60] 480 F.2d 341 (2d Cir. 1973).

[61] *Id.* at 363.

of insurance to protect corporate directors and management, thereby spreading the risk and allowing compensation to the injured victim without fear of placing unlimited liability on any one individual.[62]

The proposed ALI Federal Securities Code approaches the matter in another way. It would limit, in certain situations, the maximum civil liability which could be imposed on each defendant to either out of pocket damages or to an arbitrary dollar ceiling, except when it is shown that the defendant made the misrepresentations with knowledge of the misstatement.[63] Of course congressional action would be required before such an arbitrary limit could be set.

The probability of liability could also be limited by moderating the effects of a more liberal standard of conduct with a stricter test for materiality. Such an approach would require a factor to be more decisive and influential in the making of an investment decision in order to be material. The result would be to assure that liability would not attach if minor or less influential items were overlooked by a corporate director or officer.

Indeed, the Second Circuit realized in *Gerstle v. Gamble-Skogmo, Inc.*,[64] that when a negligence test (affirmative duty to investigate) is adopted, a strict materiality standard is necessary.[65] *Gerstle* involved a violation of rule 14a-9 which deals with proxy statement solicitation. The court established that in a rule 14a-9 suit, unlike a rule 10b-5 action, negligence is a sufficient basis for recovery, and corporate officers and directors will be held to an affirmative duty to investigate.[66] The court stated that when a more liberal standard of culpability is involved, and when there is a possibility of heavy damages, a stricter definition of materiality is necessary.[67]

The court in *Gerstle* did not clarify, however, whether the logical result of its statement would be a less severe materiality test under the rule 10b-5 inquiry notice standard. It may be very likely that the same fear of heavy damages would prompt the court to establish the more demanding materiality standard in rule 10b-5 as well as rule 14a-9 actions.

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[62] *See* Note, *Insuring Corporate Executives Against Liability Under Rule 10b-5: First Principles and Second Thoughts*, 63 NW. U.L. REV. 544 (1968). For a discussion on the impact of insurance on the law of torts, see W. PROSSER, LAW OF TORTS 547-56 (4th ed. 1971).

[63] ALI Federal Securities Code, § 1403(g)(2) (Tent. Draft No. 2, 1973).

[64] 478 F.2d 1281 (2d Cir. 1973).

[65] *Id.* at 1301-03.

[66] *Id.* at 1298-1301.

[67] *Id.* at 1302.

2. Deterrence of Fraudulent Conduct

The Second Circuit views the primary policy goal of rule 10b-5 to be the deterrence of fraudulent conduct.[68] The court feels that fraudulent activity cannot be prevented more effectively by a negligence standard (an affirmative duty to investigate) than by a standard requiring at least some degree of knowledge of the misstatement or omission.[69] This is because a negligence standard assumes that the defendant has acted in good faith, and although he has in fact acted in good faith, he may still be found liable if he did not exercise reasonable care in carrying out the investigation.[70] Deterrence of fraudulent conduct, however, as stated by the Second Circuit in *Chris-Craft*, is aimed at some degree of culpable conduct.[71] The *Lanza* court stated that it read the purpose of the rule as deterrence of fraudulent or predatory practices on the part of corporate personnel.[72] It indicated that complete good faith is a valid defense to a rule 10b-5 private action for damages.[73]

The Second Circuit feels that the inquiry notice test rests on the fringe of fraudulent conduct. Since actual fraudulent intent is not required, but some degree of culpable conduct is still involved, the deterrent aspect of the rule is furthered to the maximum extent by this standard. As stated above, however, negligence involves no greater knowing culpability than does inquiry notice. Consequently, the court feels that a negligence standard (an affirmative duty to investigate) would not further the deterrence goal of rule 10b-5.

3. A Statutory Impediment

Irrespective of policy considerations, the Second Circuit rests its inquiry notice requirement on a statutory basis. It feels that regardless of other policy considerations, the wording of § 10(b) of the Securities Exchange Act of 1934 prevents it from establishing an affirmative duty to investigate. The court stated in *Lanza v. Drexel & Co.* that the words in § 10(b) prohibiting the use of any "manipulative or deceptive devices"

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[68] Deterrence has long been a purpose of § 10(b) and rule 10b-5. *See, e.g.*, A. BROMBERG, *supra* note 13, § 8.4 (508), at 204.114.

[69] 479 F.2d at 1298-1305.

[70] When negligence is advanced as a basis for liability in non-privity trading cases, not only is the defendant's conduct based upon a less objectionable state of mind, but the deterrent effect of potential liability is weaker [than it is when some degree of knowledge is required] because under the assumptions employed here the defendant has made a good faith attempt to comply with his duties.
Ruder, *supra* note 13, at 442.

[71] 480 F.2d at 363.

[72] 479 F.2d at 1289-91.

[73] *Id.* at 1300.

negate liability for "mere negligence."[74] It further indicated in *Gerstle v. Gamble-Skogmo Corp.* that to read a negligence requirement into rule 10b-5 would exceed the SEC's authority stemming from § 10(b).[75] The court indicated that "manipulative" and "deceptive" denote active misrepresentation which necessarily involves some degree of knowledge of the existence of misstatements or omissions in investment literature. Consequently, the court believed that inquiry notice is as far as rule 10b-5 liability can be extended in private actions for damages and yet fall within § 10(b)'s authority.[76]

Technically, the court's interpretation of these words would appear to be correct. However, the Supreme Court has consistently held that § 10(b) and rule 10b-5 must be read flexibly, not technically and restrictively, to effectuate their broad remedial purposes.[77] The Second Circuit in *Lanza* purported to be following these guidelines in establishing the inquiry notice standard.[78] The Supreme Court, however, seems to reject the narrow interpretation given to "any manipulative and deceptive devices," and appears to follow the interpretation of the Ninth Circuit.[79] In *Ellis v. Carter*,[80] the Ninth Circuit suggested that it would be

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[74] *Id.* at 1305.

[75] 478 F.2d at 1298-99.

[76] 15 U.S.C. § 78j(b) (1970) (§ 10(b)):

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> (a) . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
>
> (c) . . .

17 C.F.R. § 240.10b-5 (1973) (rule 10b-5):

> It shall be unlawful for any person, directly or indirectly, by the use of any means of instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

[77] *See, e.g.*, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 185 (1963); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); Superintendent v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971).

[78] 479 F.2d at 1299.

[79] Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1971):

> These proscriptions, by statute and rule, are broad and, by repeated use of the word "any," are obviously meant to be inclusive. . . . Congress intended securities

difficult to frame the SEC's authority to promulgate rules and regulations, such as rule 10b-5, in broader terms than § 10(b)'s "*any* manipulative or deceptive devices or contrivances," and that the authority to enact rule 10b-5 was therefore present.[81]

Indeed, the Second Circuit was reversed by the Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.* for technical rather than flexible construction although the Second Circuit in the *Capital Gains* case, as it did in *Lanza*, purported to be construing broadly to effectuate the remedial purposes of the securities acts.[82] The *Capital Gains* case involved the interpretation of "device, scheme, or artifice to defraud" in the Investment Advisors Act of 1940.[83] The Supreme Court stated that these words, which are similar to those of § 10(b), were not to be read, as the Second Circuit had read them, in light of the traditional common law concepts of fraud and deceit.[84] Nevertheless, the concept of fraud has caused the Second Circuit to refrain from establishing an affirmative duty to investigate in a private rule 10b-5 action for damages.

B. *Second Circuit Objections to a Negligence Standard*

In addition to the factors which urged the Second Circuit to adopt an inquiry notice standard, there are additional factors which led the circuit to reject the imposition of an affirmative duty to investigate (a negligence standard). One such reason was stated by the court in *Lanza v. Drexel & Co.* to be the impossibility of investigating every person and thing connected with a particular transaction.[85] The court suggested that it would be unduly burdensome to require a director, particularly an outside director, to delve into all aspects of corporate business in order to avail himself of any material information which should be disclosed. The flaw in the court's reasoning, however, is that it apparently failed to realize that if an affirmative duty to investigate were adopted, as exemplified by the standard approved by the Seventh Circuit, the exercise of the duty would require only *due diligence* or *reasonable care*. If after the exercise of due diligence a material misstatement or omission had arisen, a defendant would not be liable to injured investors. The court's concern might be valid if it were speaking to a standard of *strict liability*,

legislation enacted for the purpose of avoiding frauds to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes."

80 291 F.2d 270 (9th Cir. 1961).

81 *Id.* at 274 (emphasis supplied).

82 375 U.S. at 185.

83 15 U.S.C. § 80b.

84 375 U.S. at 185.

85 479 F.2d at 1307-08.

which would hold the defendant liable regardless of the exercise of due diligence or reasonable care. But strict liability has not been discussed as a possible standard of conduct within the Second Circuit.

Another objection has been raised by the Second Circuit in opposition to the establishment of an affirmative duty to investigate. There is a fear expressed that a corporate outside director, one not directly involved in the day-to-day management of a corporation, might unfairly be subjected to liability.[86] The standard suggested by the Seventh Circuit and discussed above answers that objection.[87] It would limit liability of outside directors since the "normal business acumen" of one in that position would be relevant in determining a violation of rule 10b-5, and because the normal business acumen of an outside director would not be as extensive as that of the management personnel of the corporation. Consequently, the degree and thoroughness of investigation required on the part of an outside director would be significantly lower than that required by an insider, and therefore liability would less readily attach to an outsider.[88]

C. *Encouragement of Full Disclosure*

Significantly, the Second Circuit, in establishing an inquiry notice standard of conduct in private rule 10b-5 actions for damages, has not focused upon one important purpose of the securities acts as set forth by the Supreme Court—encouragement of full disclosure.[89] The Supreme Court has found that the Securities Exchange Act of 1934 "quite clearly falls into the category of remedial legislation."[90] Consequently, the Court has expressed the belief that "One of its central purposes is to protect investors through the requirement of full disclosure . . . ."[91]

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[86] *See, e.g.*, 479 F.2d at 1281.

[87] *See* text accompanying note 57, *supra.*

[88] While the establishment of an affirmative duty to investigate on the part of outsiders would appear to place a higher duty of care upon them than would inquiry notice, it should be noted that the same result is not necessarily true with regard to insiders. Since an insider encounters a great mass of information in carrying out his day-to-day affairs it normally would be rare for him not to have been put on notice as to the existence of material information. Consequently, the effect would normally be the same as if the insider was held to an affirmative duty to investigate. *Franchard*, however, does illustrate the exception to this proposition. There the defendant insiders were found not to be liable when measured by an inquiry notice standard since they were not placed on notice of the financial instability of the partnership's net lessee. 478 F.2d at 123-24. If, however, the defendants were required to affirmatively investigate they presumably would have been held liable if it were found that they had not investigated with reasonable care.

[89] The principle of encouragement of full disclosure of the Securities Exchange Act of 1934 was stated by the Court in SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963), and was restated in Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

[90] Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

[91] *Id.*

This goal would be more adequately met by the requirement of an affirmative duty to investigate.

It was noted above that inquiry notice promotes to the fullest extent the deterrence of fraudulent conduct.[92] However, inquiry notice would not significantly promote full disclosure since it does not require a corporate officer or director to seek out and disclose material information. It creates a passive duty the goal of which is to deter undesirable conduct rather than to promote desireable conduct.[93] An affirmative duty to investigate does stimulate desired conduct and therefore more adequately meets the goal of encouragement of full disclosure.

The positive effects of an affirmative duty to investigate can be illustrated by referring to the facts in *Cohen v. Franchard Corp.*[94] If a policy were adopted to encourage disclosure, the *Franchard* plaintiffs might have been warned of the financial instability of the net lessee and consequently might not have been involved in litigation. When a lessor, here Associates, embarks upon a long term net lease involving such a large sum of money, it is not only concerned with the prospective return on its investment, but also with the ability of the net lessee to pay the agreed upon rental rate, *i.e.* the lessee's financial stability. The loss to *current* investors of the lessor company when its management fails to investigate would undoubtedly fall within the Supreme Court's admonition that one cannot be held liable under rule 10b-5 for mere negligent corporate mismanagement.[95] However, a lessor also realizes that *prospective* investors are relying upon it to furnish them with material information, and that knowledge of the financial stability or instability of the lessee may significantly affect a decision to invest. By demanding that a corporate officer investigate, discovery of this type of information would be encouraged. Of course, this reasoning is not limited to lessor-lessee relationships. It applies to all investment opportunities. Since corporate personnel have greater access to information than prospective investors, an affirmative duty to investigate would encourage full disclosure by requiring the corporate officer or director to seek out and convey material matters to the investing public, thereby putting prospective investors on a more equal footing with corporate personnel.

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[92] *See* discussion following text accompanying note 73, *supra*.

[93] *See* A. BROMBERG, *supra* note 13, § 8.4(508) at 204.114-15; Ruder, *supra* note 13, at 441.

[94] 478 F.2d 115 (2d Cir. 1973).

[95] ". . . Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement." Superintendent v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971).

III. CONCLUSION

The Second Circuit, after initially rejecting a fraud requirement and appearing to establish a negligence standard in rule 10b-5 private actions for damages, then engaged in a retreat from negligence. Now it appears to have solidified its position and to have adopted an inquiry notice standard, which places a duty upon corporate personnel to investigate material information only after having received information sufficient to put them on notice as to possible material misstatements or omissions in investment literature.

A statutory impediment—the reading by the court of § 10(b) as requiring some form of fraudulent conduct to give rise to liability in private rule 10b-5 damage actions—prevails as the primary factor preventing the Second Circuit from establishing an affirmative duty to investigate. However, if the words construed in the *Capital Gains* case have been liberated from their common law confines, there appears to be no reason to require § 10(b)'s "manipulative and deceptive devices" to be viewed in light of traditional concepts of common law fraud and therefore to require "some form of scienter." The Second Circuit should, therefore, free itself from its self-imposed statutory restrictions and proceed to consider more fully, in light of the Supreme Court's rulings, the relevant policy considerations.

James R. Shenk